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Methvin v. Commissioner: A Decision Worth Watching

-by Neil E. Harl*

A very brief decision by the Tenth Circuit Court of Appeals on June 24, 2016, *Methvin v. Commissioner*,[1] bears watching, not because it affects, directly, the agricultural sector, but because of what it likely portends. The case involved liability for self-employment tax for investors who are not partners in a partnership but were swept up by the language of the Internal Revenue Code defining a "partnership and partner" as including ". . .a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."[2]

That language effectively disregards the meaning of those terms under state law, as proved to be the case in the *Methvin* case.

What the case involved

The *Methvin* case involved a taxpayer with a two to three percent interest in various oil and gas ventures.[3] In the year in question, the taxpayer reported $6,760 in net income reported as "other income" on Form 1040. In Article 14 of the agreement between the taxpayer and the operating entities, the parties to that document elected "to exclude from the application of sub-chapter K" of the Internal Revenue Code.[4] On audit, the taxpayer argued that he was not engaged in a trade or business and was not a partner or a partnership. Both sides of the controversy apparently agreed that the management involvement was "minimal." One case, *Cokes v. Commissioner*,[5] which was heavily relied upon by both the Tax Court and the Tenth Circuit,[6] *involved a 42.9 percent working interest*.

In the face of that leap downward in terms of involvement, the courts agreed that the incomes from the "working interests" were from a "pool or joint venture for operation of the wells."

So how does that affect farmers and ranchers (or those who invest in agricultural properties?

The role of material participation. The impact on agricultural investments, at the moment at least, is likely to be slight. First of all, after providing for an exclusion from self-employment tax,[7] the statute states ". . . the preceding provisions of this paragraph

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shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement between the owner or tenant and another individual which provides such other individual shall produce agricultural or horticultural commodities . . . on such land, and that there shall be material participation by the owner or tenant. . . in the production or the management of the production of such agricultural or horticultural commodities and (B) there is material participation. . . . " That language *does not apply to other kinds of entities engaged in something other than the production of agricultural or horticultural commodities*. Although Congress might not have realized the importance of that limitation, it is there and creates a barrier to assessing self-employment tax where the involvement is less than "material participation."

It is entirely possible that the Department of the Treasury could possibly take the position that the quoted language does not prevent imposing self-employment tax on those *not* meeting the material participation test but that seems unlikely.

The recent history of trying to expand self-employment tax liability. The checkered history of trying to expand self-employment tax liability with specific targeting of farm and ranch taxpayers has been something less than successful. In the *Mizell* controversy[8] the Eighth Circuit Court of Appeals rebuffed attempts to impose self-employment tax on rental income of farmland, adding involvement as lessor to involvement in the farming or ranching entity.[9]

In the battle over the imposition of self-employment tax on government payments such as the Conservation Reserve Program, the Eighth Circuit Court of Appeals reversed the Tax Court's holding in favor of the Government's point of view.[10]

In conclusion

The problem is not so much with Congressional enactments; the problems have been with attempts to expand beyond what was anticipated by the Congress. The disagreements over whether those moves by the tax administering bodies in the Administration go beyond Congressional intent will likely go on., . . and on . . . and will be refereed by the judicial system. For relatively small taxpayers, in particular, that imposes an unfair financial burden on the targeted taxpayers to resist the shift in tax administration.

ENDNOTES

[1] 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).

[2] I.R.C. § 7701(a)2). See Treas. Reg. § 301.7701-1(a)(2).

[3] T.C. Memo. 2015-81, *aff'd,* 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).

[4] As is widely known, Subchapter K includes Sections 701 through 777 of the bulk of partnership tax law.

[5] 91 T.C. 222 (1988).

[6] T.C. Memo. 2015-81, *aff'd,* 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).

[7] I.R.C. § 1402(a)(1).

[8] Mizell v. Comm'r, T.C. Memo. 1995-571. See generally 5 Harl, *Agricultural Law* § 37.03[3][a][i] (2016); 2 Harl, *Farm Income Tax Manual* § 8.05[5] (2016 ed.); Harl, *Agricultural Law Manual* § 4.06[3][a] (2016).

[9] McNamara, *et al*. v. Comm'r, 236 F.3d 410 (8th Cir. 2000), *non-acq*., I.R.B. 2003-42.

[10] Morehouse v. Comm'r, 769 F.3d 616 (8th Cir. 2014). See Harl, "Surprising Move by the Tax Court on Self-Employment tax Liability," 140 *Tax Notes* 931 (August 26, 2013); Harl, "The Eighth Circuit Reverses the Tax Court in *Morehouse v. Commissioner*," 25 *Agric. L. Dig*. 161 (2014).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

FEDERAL FARM PROGRAMS

ANIMAL WELFARE ACT. The APHIS has issued proposed regulations amending the Animal Welfare Act (AWA) regulations in response to the 2014 Farm Bill amendment to the Act that provides the Secretary of Agriculture with the authority to determine that animal dealers and exhibitors are not required to obtain a license under the Act and regulations if the size of the business conducting AWA-related activities is determined to be *de minimis* by the Secretary. The APHIS has reviewed past compliance with the AWA of currently-regulated facilities and has determined that *de minimis* businesses, as defined in the rule are capable of providing adequate care and treatment of the animals involved in regulated business activities. The proposed regulations exclude from the definition of "exhibitor" some owners of household pets that are exhibited occasionally, generate less than a substantial portion of income, and reside exclusively with the owner. Dealers and exhibitors operating at or below the thresholds determined for their particular AWA-related business activity would be exempted from federal licensing requirements established under the AWA and regulations. **81 Fed. Reg. 51386 (Aug. 4, 2016)**.

GRAIN STANDARDS. The GIPSA has adopted as final regulations revising existing regulations and adding new regulations under the United States Grain Standards Act (USGSA), as amended, in order to comply with amendments to the USGSA made by the Agriculture Reauthorizations Act of 2015. The new regulations eliminate mandatory barge weighing, remove the discretion for emergency waivers of inspection and weighing, revise GIPSA's fee structure, revises exceptions to official agency geographic boundaries, extend the length of licenses and